

GOODBYE TO THE CONTEMPORANEOUS OWNERSHIP REQUIREMENT

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ABSTRACT

The General Assembly should amend the Delaware General Corporation Law to eliminate the contemporaneous ownership requirement for derivative actions from section 327. The rule is incoherent and ill-suited to each of the purposes advanced to support it. The rule is also unnecessary, as defendants and the Delaware courts have ample alternative avenues available for dealing with meritless claims.

I. INTRODUCTION

The Delaware General Corporation Law (DGCL) has functioned well over the four decades since its 1967 overhaul, but there remain opportunities for improvement. One such opportunity lies in section 327, which establishes the contemporaneous ownership requirement for stockholder derivative actions. Under this section, if a stockholder-plaintiff does not own stock at the time the wrong is inflicted on the corporation, the stockholder lacks standing to sue.¹ Despite the rule's long existence, it is fundamentally incoherent. It is ill-suited to each of the purposes advanced to support it. It operates largely at random, and it arbitrarily mandates the dismissal of potentially meritorious claims. The rule is also unnecessary, as defendants already have numerous avenues to dispose of meritless derivative actions. The Delaware General Assembly should amend section 327 to require only that a derivative plaintiff (1) hold stock at the time of the lawsuit and (2) not voluntarily divest the stock during the lawsuit.²

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¹Section 327 provides that "[i]n any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains . . ." DEL. CODE ANN. tit. 8, § 327 (2001). The same requirement appears in Delaware Court of Chancery Rule 23.1. See DEL. CT. CH. R. 23.1(a). Although the statute and rule speak only of derivative actions, the Delaware Court of Chancery has extended the contemporaneous ownership requirement to plaintiffs asserting direct (as opposed to derivative) claims. See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 809 A.2d 1163, 1169-70 (Del. Ch. 2002). The assertion of direct claims by an after-acquiring stockholder presents different issues and is beyond the scope of this article.

²The amended statute could read, "In any derivative suit instituted by a stockholder of a

II. THE 1967 REVISION: MAINTAINING THE STATUS QUO

Section 327 is "the only statutory provision dealing with derivative actions."³ It originally was adopted in 1945.⁴ As part of the 1967 revision of the DGCL, the Delaware Corporation Law Revision Committee commissioned a review of the DGCL by Professor Ernest L. Folk, III, of the University of Virginia School of Law. In his section entitled "Shareholder Derivative Suits," Professor Folk recommended that Delaware maintain the status quo: "The view of this Report is that the existing Delaware controls are adequate to bar abuse of the derivative action, unless the premise (rejected by this Report) is that all shareholder suits are undesirable and should be discouraged."⁵

Professor Folk identified the "existing controls" as: (1) the requirement of contemporaneous stock ownership, (2) demand upon directors, and (3) mandatory court approval for settling or dismissing actions.⁶ He concluded that:

[t]ogether these procedures bar the purchased suit, require reasonable exhaustion of intra-corporate remedies, and bar secret settlements and pay-offs. Of these, court approval for dismissed or settled action is the most important and effective device, and at the same time the fairest method for balancing the corporate interest in immunity from groundless or "strike" actions and the policy favoring private enforcement of fiduciary duties.⁷

Professor Folk concluded that "[a]ccordingly, the recommendation of this Report is that the present system of controls be retained intact (with one or two minor changes) and that no additional restrictions be imposed, at least absent a 'clear and present danger' of abuses with which existing procedures are patently unable to cope with [sic]."⁸

In commenting specifically on the contemporaneous ownership requirement, Professor Folk's observations were brief: "This [contemporaneous

corporation, it shall be averred that the plaintiff is a stockholder of the corporation." The amended statute, thus, would retain the continuous ownership requirement, which mandates that a stockholder own stock at the time of the lawsuit and continuously throughout its prosecution.

³EDWARD P. WELCH ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 327.1, at GCL-XIII-42 (5th ed. Supp. 2007).

⁴1945 Del. Laws c. 157.

⁵ERNEST L. FOLK, III, *REVIEW OF THE DELAWARE CORPORATION LAW 97* (1967), available at <http://law.widener.edu/LawLibrary/Research/OnlineResources/DelawareResources/DelawareCorporationLawRevisionCommittee.aspx>.

⁶*Id.*

⁷*Id.*

⁸*Id.* at 97-98.

ownership] requirement in Section 327 and Chancery Rule 23(b), precluding the evil of purchased rights to bring derivative actions, is unquestionably sound, and its language is adequate for the purpose."⁹ In a footnote, Professor Folk recognized that "[s]ome writers view the contemporaneous ownership requirement as inconsistent with the concept of the suing shareholder as a guardian *ad litem* of the corporate interest suing for a corporate recovery."¹⁰ He continued: "Even though this is so, abolishing the Section 327 requirement does not follow, since clearly the policy of eliminating the purchased suit can outweigh the policy of effective private enforcement of fiduciary obligations. *In all events, this Report does not regard repeal of Section 327 as an open question.*"¹¹ Professor Folk recommended only that the statute be amended to "codify case-law permitting beneficial, equitable owners to bring actions" and to "codify the 'continuing wrong' theory, a judicial gloss on the literal wording of Section [327]."¹²

After receiving Professor Folk's report, the Delaware Corporation Law Revision Committee asked Irving Morris, a member of the committee and a leading member of the Delaware plaintiffs' bar, to review and comment on Professor Folk's recommendations for derivative actions.¹³ Mr. Morris agreed with Professor Folk's overall views, but recommended that the committee not take the step of codifying the judicial decisions in this area.¹⁴

Mr. Morris's only comment on the contemporaneous ownership rule appeared as an aside. In recommending that the committee reject Professor Folk's call to amend section 327 to codify the principle that beneficial holders can sue derivatively, Mr. Morris observed that "an equitable stockholder may bring a derivative action *provided, of course, he was a stockholder at the time of the [wrong] . . . as required by Section 327.*"¹⁵ He thus took section 327 as a given.

Professor Folk, Mr. Morris, and the committee do not appear otherwise to have addressed the contemporaneous ownership requirement. Based on Professor Folk's report and Mr. Morris's memorandum, the committee did not

⁹FOLK, *supra* note 5, at 98 (citing *Rosenthal v. Burry Biscuit Corp.*, 60 A.2d 106 (Del. Ch. 1948)).

¹⁰*See id.* at 98 n.18.

¹¹*Id.* (emphasis added).

¹²*Id.* at 97-98.

¹³Memorandum from Irving Morris to the Members of the Delaware Corporation Law Revision Committee 1 (Oct. 1, 1964), available at <http://law.widener.edu/LawLibrary/Research/OnlineResources/DelawareResources/DelawareCorporationLawRevisionCommittee.aspx>.

¹⁴*Id.* at 2.

¹⁵*Id.* at 4 (emphasis added).

make any changes in section 327. Forty years later, the time has come to reconsider these conclusions.

III. INCOHERENCE AT THE OUTSET: A FUNDAMENTAL DISCONNECT WITH THE NATURE OF THE DERIVATIVE ACTION

As Professor Folk recognized, section 327 fundamentally conflicts with the basic nature of a derivative action.¹⁶ Section 327 focuses on the stockholder asserting the claim. A derivative claim, however, belongs to the corporation, not the suing stockholder.

"Devised as a suit in equity, the purpose of the derivative action was . . . to protect the *interests of the corporation* from the misfeasance and malfeasance of 'faithless directors and managers.'"¹⁷ The fundamental purpose of a derivative action is "to *enforce a corporate right* that the corporation has refused for one reason or another to assert."¹⁸ Any recovery goes to the corporation, not the suing stockholder.¹⁹

Because the corporation is the real party in interest, the stockholder's only right and interest in the derivative action is to cause the corporation to sue.²⁰

The stockholder does not bring such a suit because *his* rights have been *directly* violated, or because the cause of action is *his*, or because *he* is entitled to the relief sought; he is permitted to sue in this manner *simply in order to set in motion the judicial machinery of the court . . .* In fact, the plaintiff has no such *direct* interest; the defendant corporation alone has a direct interest . . .²¹

¹⁶See FOLK, *supra* note 5, at 98 n.18 (observing that "[s]ome writers view the contemporaneous ownership requirement as inconsistent with the concept of the suing shareholder as a guardian *ad litem* of the corporate interest suing for a corporate recovery[,] and then noting "[e]ven though this is so").

¹⁷Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95 (1991) (quoting Cohen v. Beneficial Loan Corp., 337 U.S. 541, 548 (1949)) (emphasis added).

¹⁸1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 13.9, at 13-20 (3d. ed. Supp. 2006) (emphasis added).

¹⁹WELCH ET AL., *supra* note 3, at GCL-XIII-43 (citing Sternberg v. O'Neil, 550 A.2d 1105, 1124 (Del. 1988)).

²⁰*In re* Maxxam, Inc./Federated Dev. S'holders Litig., 698 A.2d 949, 956 (Del. Ch. 1996).

²¹Schoon v. Smith, 953 A.2d 196, 202 (Del. 2008) (quoting 4 POMEROY'S EQUITY JURISPRUDENCE § 1095, at 278 (5th ed. 1941) (final emphasis added by Delaware Supreme

As Professor Folk observed, the stockholder sues on behalf of the corporation in a manner analogous to "next friend" status.²² Yet, in spite of the nature of a derivative claim, section 327 operates to dismiss corporate claims based on the peculiarities of the stockholders who assert them.

The illogic of section 327 becomes all the more apparent when the derivative action is bifurcated into its component parts. Under the standard formulation, the derivative suit has a twofold nature. First, it is the equivalent of a suit by the stockholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the stockholders on its behalf, against those liable to it.²³ Of these two elements, the aspect more closely linked to the stockholder is the effort to compel the corporation to sue. The "wrong" for this portion of the action is the failure of the board to pursue an otherwise valid claim. That "wrong" is suffered by every current stockholder of the corporation, regardless of when they purchased their shares. An after-acquiring stockholder, therefore, should have standing to put the wheels of the derivative lawsuit into motion.

Once the lawsuit is properly commenced, the second aspect of the derivative action takes primacy, because it is the corporation's claim that is actually litigated. During this phase, the interests of the corporation are paramount. Indeed, it is because of the corporation's interests that Delaware authorized the device of the special litigation committee, by which a board of directors can reassert control over a derivative claim after the denial of a motion to dismiss.²⁴

In light of the corporate nature of the claim, the timing of the stockholder-plaintiff's acquisition of shares should not interfere with the pursuit of the litigation on the corporation's behalf. From the corporation's standpoint, it does not matter who brings the claim or when the stockholder bought stock. The corporation benefits regardless. Accordingly, for a derivative claim, it should not matter whether the party asserting the cause of action purchased stock before or after the wrong.

IV. INCOHERENCE OF PURPOSE: A RULE WITHOUT JUSTIFICATION

The contemporaneous ownership rule also lacks any coherent purpose. A series of rationales have been cited to justify the requirement. The rule's

Court)).

²²FOLK, *supra* note 5, at 98.

²³WELCH ET AL., *supra* note 3, at GCL-XIII-44. *See also* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("The nature of the action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.").

²⁴*See, e.g., Zapata Corp. v. Maldonado*, 430 A.2d 779, 784-85 (Del. 1981).

original purpose was to prevent the collusive creation of federal diversity jurisdiction. In Delaware, the rule was historically justified as a means of avoiding the "evil"²⁵ of a stockholder purchasing shares and subsequently filing suit. Most recently, it has been justified as preventing meritless strike suits. None of these purposes fit coherently with the operation or impact of the rule, nor do they support the continued inclusion of section 327 in the DGCL.

A. *Preventing Collusive Federal Jurisdiction*

The contemporaneous ownership requirement originally was created as a matter of equity in 1881 by the United States Supreme Court.²⁶ The Court crafted the rule to prevent corporations from manufacturing diversity jurisdiction for claims against third parties.²⁷

The problem the Supreme Court identified was that "the corporations created by the laws of the States bring a large part of their controversies with their neighbors and fellow-citizens into the courts of the United States for adjudication, instead of resorting to the State courts, which are their natural, their lawful, and their appropriate forum."²⁸ As the Court explained,

It is not difficult to see how this has come to pass. A corporation having such a controversy, which it is foreseen must end in litigation, and preferring for any reason whatever that this litigation shall take place in a Federal court, . . . has recourse to a holder of one of its shares, who is a citizen of another State. This stockholder is called into consultation, and is told that his corporation has rights which the directors refuse to enforce or to protect. He instantly demands of them to do their duty in this regard, which of course they fail or refuse to do, and thereupon he discovers that he has two causes of action entitling him to equitable relief in a court of chancery; namely, one against his own company . . . for refusing to do what he has requested them to do; and the other against the party which contests the matter in controversy with that corporation. These two causes of action he combines in an equity suit in the Circuit Court of the United

²⁵Rosenthal v. Burry Biscuit Corp., 60 A.2d 106, 111 (Del. Ch. 1948).

²⁶See Hawes v. Oakland, 104 U.S. 450, 461 (1881).

²⁷See *Burry Biscuit*, 60 A.2d at 111 n.4.

²⁸*Hawes*, 104 U.S. at 452.

States, because he is a citizen of a different State, though the real parties to the controversy could have no standing in that court.²⁹

The Supreme Court further observed that "[i]f no non-resident stockholder exists, a transfer of a few shares is made to some citizen of another State, who then brings the suit."³⁰

To put a halt to these abuses, the Supreme Court instructed the federal courts to begin enforcing a recently adopted statute that empowered them to dismiss any action that appeared to result from an "improper and collusive" attempt to create federal jurisdiction.³¹ The Court went on to articulate a list of requirements for a derivative action. This list included, without explanation, the requirement that the plaintiff allege that he "was a shareholder at the time of the transactions of which he complains, or that his shares have devolved upon him since by operation of law."³²

The problem of collusively created *federal* diversity jurisdiction obviously does not afflict the *state* courts of Delaware, whose jurisdiction does not turn on diversity of citizenship. The Delaware Court of Chancery generally has jurisdiction over equitable matters such as a stockholder derivative action involving a Delaware corporation, regardless of the citizenship of the stockholder-plaintiff. The purpose that animated the original creation of the contemporaneous ownership requirement, therefore, cannot justify the Delaware version that appears in section 327.

B. Preventing the "Evil" of a Purchased Lawsuit

Although Delaware courts have noted the federal origins and the seminal purpose of the contemporary ownership rule, they understandably have not relied on them. Instead, according to Delaware case law, section 327 and its predecessor "were enacted solely 'to prevent what has been considered an evil, namely, the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of

²⁹*Id.* at 452-53.

³⁰*Id.* at 453.

³¹*Id.* at 459.

³²*Hawes*, 104 U.S. at 461. The Supreme Court also introduced the requirements of demand and demand futility:

[H]e should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes And he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it.

Id. at 460-61.

the stock."³³ Indeed, preventing this "evil" has been described as the "sole purpose of section 327."³⁴ As part of the 1967 revision process, Professor Folk cited this purpose as well, describing it without analysis as "unquestionably sound."³⁵

Perhaps because the premise has never been questioned, the cases do not explain why a lawsuit by an after-acquiring stockholder constitutes an "evil."³⁶ From a Delaware law perspective, the "evil" cannot lie in the transfer of the right to sue. Equitable claims for breach of fiduciary duty, such as those typically asserted in derivative actions, are freely assignable under Delaware law.³⁷

Nor can the evil lie in the transfer of the right to sue as an incident of the transfer of shares. Delaware courts are able to grant defendants broad trans-actional releases precisely because the right to sue passes with transferred shares. In a March 2008 decision, the Delaware Supreme Court reaffirmed the long-standing proposition that the right to sue passes from the person who held shares as of the date of injury to "their transferees, successors, and assigns."³⁸

[W]hen a claim is asserted on behalf of a class of stockholders challenging the fairness of the terms of a proposed transaction

³³Schoon v. Smith, 953 A.2d 196, 203 (Del. 2008) (quoting Rosenthal v. Burry Biscuit Corp., 60 A.2d 106, 111 (Del. Ch. 1948)).

³⁴Shaev v. Wyly, No. 15,559-NC, 1998 Del. Ch. LEXIS 2, at *13 n.19 (Del. Ch. Jan. 6, 1998).

³⁵See FOLK, *supra* note 5, at 98 (describing the purpose of section 327 as "precluding the evil of purchased rights to bring derivative actions").

³⁶The Delaware Court of Chancery likewise did not explain the "evil" when extending the contemporaneous ownership rule to direct actions. See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 809 A.2d 1163, 1169 (Del. Ch. 2002). The court took as a given that there was "a longstanding Delaware public policy against the 'evil' of purchasing stock in order 'to attack a transaction which occurred prior to the purchase of the stock.'" *Id.* (quoting *Burry Biscuit*, 60 A.2d at 111). After noting that "[t]he policy against purchasing lawsuits involving the internal relations of Delaware corporations was codified in the derivative suit context by [section 327]," the court held that "[t]he policy animating [section 327] is not however, limited to derivative claims alone" but rather "is derived from 'general equitable principles . . .'" *Id.* at 1169-70 (citation omitted). Having started from the premise that Delaware has a "strong policy against the purchase of a lawsuit," it was a simple matter to apply that policy, unexamined, to bar direct actions by after-acquiring stockholders. *Id.* at 1170.

³⁷See *In re Emerging Commc'ns., Inc. S'holders Litig.*, No. 16,415, 2004 Del. Ch. LEXIS 70, at *106-07 (Del. Ch. May 3, 2004) (revised June 4, 2004). Generally a right of action is transferable if it is the type of claim that would survive the death of the assignor and pass to his personal representative. See *Indus. Trust Co. v. Stidham*, 33 A.2d 159, 160-61 (Del. Super. Ct. 1942). By statute in Delaware, "All causes of action, except actions for defamation, malicious prosecution, or upon penal statutes shall survive." DEL. CODE ANN. tit. 10, § 3701 (2008).

³⁸*In re Phila. Stock Exch., Inc.*, 945 A.2d 1123, 1139 (Del. 2008).

under Delaware law, the class will ordinarily consist of those persons who held shares as of the date the transaction was announced and their transferees, successors and assigns.³⁹

This is possible because when a stockholder sells shares, "the claim relating to the . . . transaction passe[s] to his purchaser," who then "enjoy[s] the benefits of [it] . . ." ⁴⁰ This is true for both class and derivative claims.⁴¹

In the face of this case law, section 327 creates an incoherent situation in which the right to benefit from the lawsuit passes to the transferee, but the right to sue does not. Moreover, because the selling stockholder no longer has stockholder status, the right to sue with respect to those shares is extinguished by the sale.⁴² Yet, somehow, the right to release claims—and to do so on behalf of both the selling stockholder and the purchasing stockholder—survives and is transferred. There is a simple way to restore coherence: if the right to participate in a settlement and receive the benefits passes to a successor stockholder, the right to assert the claim likewise should pass to a successor stockholder.

³⁹*In re Prodigy Commc'ns Corp. S'holders Litig.*, No. 19,113, 2002 Del. Ch. LEXIS 95, at *11 (Del. Ch. July 26, 2002) (quoting *In re Triarc Cos., Class & Derivative Litig.*, 791 A.2d 872, 878-79 (Del. Ch. 2001)).

⁴⁰*Id.* at *13.

⁴¹*See In re Triarc*, 791 A.2d at 875 ("Those persons [who sold their shares] chose to dissociate their economic interests from the corporation and, by doing so, to forego the opportunity to benefit from either the equitable relief aspects of the class claims or the potential benefit to the corporation from the derivative claims."). In *Triarc*, the Delaware Court of Chancery approved a settlement that released the class and derivative claims that could have been asserted by stockholders who sold their shares following the wrong but prior to the judgment, despite the fact that those persons did not receive any consideration from the settlement. The court readily accepted that the after-acquiring stockholders were receiving the principal benefits of the settlement, with no benefits for the selling stockholders. *Id.* at 878-79.

[I]t is unavoidable that persons who sever their economic relationship with the corporation during the litigation will not benefit from a settlement or a judgment in favor of the class. Those persons are viewed as having sold their interest in the claim with their shares, and there is nothing unfair or unreasonable about a judgment that bars their later assertion of an insubstantial claim for money damages alleged to arise out of the same act or transaction.

Id. at 879.

⁴²*See Lewis v. Anderson*, 477 A.2d 1040, 1049 (Del. 1984) ("A plaintiff who ceases to be a shareholder, whether by reason of a merger or for any other reason, loses standing to continue a derivative suit.").

C. *The "Evil" of "Litigious Motives"*

Since the mere transfer of the right to sue to a successor stockholder is not inherently "evil," the next gradation of potential "evil" lies in the purchasing stockholder's intent. In this guise, the primary purpose behind the contemporaneous ownership rule is to prevent individuals from purchasing shares "with litigious motives."⁴³ The rule prevents courts "from being used to litigate purchased grievances or from becoming a party to speculative suits against corporations."⁴⁴

The obvious problem with this explanation is that section 327 does not turn on intent. Motivation is not mentioned in the statute, and the courts have not applied any intent-based test. To the extent the contemporaneous ownership rule is premised on identifying those stockholders who purchased shares with litigious motives, the rule does not serve its purpose.⁴⁵

Without any inquiry into individual intent, the attempt to justify section 327 as a rule against "litigious motives" recalls the venerable doctrines of champerty and maintenance.⁴⁶ In Delaware, however, these doctrines were never applied in the same manner as section 327, viz., as an across-the-board

⁴³See *Ala. By-Prod. Corp. v. Cede & Co.*, 657 A.2d 254, 264 n.12 (Del. 1995) (identifying the policy underlying section 327 as concern about suits brought by "an individual [who] purchases stock in a corporation with purely litigious motives"); *Schreiber v. Bryan*, 396 A.2d 512, 516 (Del. Ch. 1978) (same); see also Sarah Wells, Comment, *Maintaining Standing in a Shareholder Derivative Action*, 38 U.C. DAVIS L. REV. 343, 349 (2004) (asserting that the "ownership period requirements" for derivative actions "seek to identify plaintiffs who will best represent the injured corporation" and that "[o]f foremost concern is the prevention of purchased lawsuits by professional plaintiffs").

⁴⁴13 WILLIAM MEADE FLETCHER ET AL., *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 5981.10 (perm ed., rev. vol. 2004).

⁴⁵DEL. CODE ANN. tit. 8, § 327 (2001). The absence of intent-based language in section 327 contrasts with section 220 of the DGCL, which explicitly requires a stockholder seeking books and records to have a "proper purpose" for making the requested. *Id.* § 220(b). Delaware courts apply this requirement by inquiring on a case-by-case basis into the individual motives of the stockholder seeking the books and records. See, e.g., *CM & M Group, Inc. v. Carroll*, 453 A.2d 788, 792 (Del. 1982) ("The paramount factor in determining whether a stockholder is entitled to inspection of corporate books and records is the propriety of the stockholder's purpose in seeking such inspection. . . . The Court of Chancery is to determine the propriety of the purpose from the facts in each case.") (citations omitted).

⁴⁶Maintenance is "officious intermeddling in a suit which in no way belongs to the intermeddler, by maintaining or assisting either party to the action, with money or otherwise, to prosecute or defend it." 14 AM. JUR. 2D *Champerty & Maintenance* § 1 (2000). Champerty is "a type of maintenance in which the intermeddler makes a bargain with one of the parties to the action to be compensated out of the proceeds of the action." *Id.*; see also *Gibson v. Gillespie*, 152 A. 589, 593 (Del. Super. Ct. 1928) (describing champerty as "an agreement between the owner of a claim and a volunteer that the latter may take the claim and collect it, dividing the proceeds with the owner, if they prevail; the champertor to carry on the suit at his own expense").

bar to litigation. They only applied to "volunteers" or "strangers" to the dispute.⁴⁷ An assignment of claims was not void "where the assignee has some legal or equitable interest in the subject matter of the litigation independent from the terms of the assignment."⁴⁸ The purchase of stock, which necessarily gives the acquirer an equitable interest in the underlying corporation, should satisfy this requirement.⁴⁹ Section 327's blanket rule, therefore, does not make sense as a modern day descendant of the otherwise near-extinct doctrines of champerty and maintenance.

A "litigious motives" rationale for section 327 also causes the statute to duplicate with a blanket rule the more discerning inquiry that a trial court already can conduct into the motives of a derivative plaintiff. In any derivative action, the stockholder sues in a representative capacity, and the defendants have the power to challenge the suitability of the derivative plaintiff, including the stockholder's motives for bringing suit.⁵⁰ A stockholder-plaintiff can be disqualified and dismissed for having improper motives or being otherwise unsuitable.⁵¹

Finally, any valid concern about "litigious motives" should depend on what the after-acquiring stockholder can achieve. If a derivative action could result in disproportionate recovery through an award of punitive damages, then the threat of "litigious motives" might have greater purchase. In an equitable

⁴⁷Drake v. Nw. Natural Gas Co., 165 A.2d 452, 454 (Del. Ch. 1960) (explaining that "the concept of common law champerty was never adopted in toto in Delaware, our courts having consistently declined to condemn as champertous, assignments in which the assignee had any legal or equitable interest in the subject matter other than by terms of the agreement under which the suit was brought").

⁴⁸St. Search Partners, L.P. v. Ricon Int'l, L.L.C., No. 04C-09-191-PLA, 2006 Del. Super. LEXIS 200, at *12 (Del. Super. Ct. May 12, 2006).

⁴⁹See *In re Emerging Commc'ns, Inc. S'holders Litig.*, No. 16,415, 2004 Del. Ch. LEXIS 70, at *107 (Del. Ch. May 3, 2004) (revised June 4, 2004). In *Emerging*, the Delaware Court of Chancery upheld a plaintiff's attempt to assert breach of fiduciary duty claims on behalf of the former holders shares who sold the plaintiff the "litigation rights" associated with their shares. *Id.* at *104-05. The court held that the agreement was not champertous and found no prejudice to the defendants because they would have faced a class claim on behalf of all stockholders in any event. *Id.* at *107, 109. The same is true in a derivative lawsuit, where the prior holder and other continuing holders otherwise could assert the claim with no reduction in the potential liability to the corporation. The *Emerging* court cited two factors supporting its holding that the stockholder acquiring the rights had been a stockholder at the time of the challenged transaction and always had the right and standing to pursue a fiduciary duty claim. *Id.* at *107. Since those observations merely echo the requirements of the contemporaneous ownership requirement, they do not provide independent justification for the rule itself.

⁵⁰See, e.g., *In re Dairy Mart Convenience Stores, Inc.*, No. 14,713, 1999 Del. Ch. LEXIS 94, at *25-26 (Del. Ch. May 24, 1999), reprinted in 25 DEL. J. CORP. L. 411, 426-27 (2000).

⁵¹*Id.* at *29-31, reprinted in 25 DEL. J. CORP. L. at 428-30 (assessing motivations and suitability of derivative plaintiff that was a competitor of nominal defendant corporation).

claim such as a derivative action for breach of fiduciary duty, however, punitive damages are not available.⁵² The Delaware Court of Chancery does not have jurisdiction to award punitive damages, only compensatory damages.⁵³ The most that a derivative plaintiff can achieve is to remedy the underlying wrong.

It may well be that in the absence of the contemporaneous ownership requirement, some stockholders would acquire shares with "litigious motives" and bring derivative lawsuits. Some of these lawsuits may also lack merit. Given the existing frequency of derivative litigation, however, any uptick (if there is one) should be marginal, and as discussed below, Delaware law in general, and defendants in particular, have numerous ways to deal with meritless claims and dispose of derivative actions. A plaintiff who can effectively vindicate corporate rights should not be prevented from conferring benefits on the corporation via a derivative action simply because the wrong occurred before the plaintiff purchased its shares.

D. *The "Evil" of a "Windfall"*

Moving beyond "litigious motives," another proffered basis for the "evil" that animates section 327 is fear that the after-acquiring stockholder will obtain a "windfall." For example, "subsequent purchasers of shares could reap a windfall from any recovery in a derivative proceeding which was not considered in the purchase of their shares."⁵⁴ This is said to occur because, "[o]nce the corporation recovers proceeds through the litigation, the stock price will increase, thus resulting in a windfall to the shareholder."⁵⁵ Under

⁵²Beals v. Wash. Int'l, Inc., 386 A.2d 1156, 1159 (Del. Ch. 1978) ("Traditionally and historically the Court of Chancery as the Equity Court is a court of conscience and will permit only what is just and right with no element of vengeance and therefore will not enforce penalties or forfeitures.").

⁵³*Id.*; accord Gesoff v. IIC Indus. Inc., 902 A.2d 1130, 1154 (Del. Ch. 2006) ("Obviously, the court cannot award punitive damages."); Xperex Corp. v. Viasystems Techs. Corp., LLC, No. 20,582-NC, 2004 Del. Ch. LEXIS 172, at *11 n.13 (Del. Ch. July 22, 2004) ("I also must point out an issue not raised by either party—punitive damages. Viasystems' amended counterclaim seeks punitive damages as relief for various causes of action. Without mincing words, Viasystems' attempt to seek punitive damages in this Court is frivolous.").

⁵⁴FLETCHER ET AL., *supra* note 44, § 5981.10; see generally Robbie G. Yates, Aurora Credit Services, Inc. v. Liberty West Development, Inc.: *An Analysis of Shareholder Derivative Suits in Closely Held Corporations*, 2002 BYU L. REV. 175, 181.

⁵⁵Yates, *supra* note 54, at 182 n.28; see also Wells, *supra* note 43, at 349 ("[S]o-called professional plaintiffs look for injured companies, as reflected in depressed stock prices, and purchase stock so that they may act as plaintiff in a derivative suit. They hope to reap a windfall in these purchased suits if the corporate fund is successfully replenished by a damage award.") (footnote omitted).

this view, the continuous ownership requirement serves to "prevent shareholders from buying into a corporation at a devalued price and then receiving a windfall from advantageous litigation on matters that occurred prior to their ownership of the stock."⁵⁶

The "windfall" concept does not make sense as a matter of financial and economic theory. If the corporation's shares are publicly traded and the underlying facts giving rise to the wrong have been disclosed, then the market price of the stock will take into account not only the loss in value resulting from the harm, but also the asset value of the contingent derivative claim.⁵⁷ As the Delaware courts have recognized, the value of a contingent derivative claim consists of the net potential recovery (i.e., net of attorneys' fees and other costs) discounted by the likelihood of success (taking into account all potential defenses).⁵⁸ When a stockholder sells, the value he receives takes into account the value of this contingent claim. When a purchasing stockholder buys, he pays the fair market value for the right to participate in the potential upside. An after-acquiring stockholder does not receive a "windfall" if the corporation is able to recover on the claim any more so than he receives a "windfall" if the corporation is able to beat its projected operating results. The after-acquiring stockholder simply realizes the contingent value he paid for when he acquired his shares.

Delaware decisions apply these principles. When determining the fair value of a Delaware corporation in a statutory appraisal under section 262 of the DGCL,⁵⁹ Delaware courts value the contingent assets represented by derivative claims on file at the time of the merger giving rise to appraisal rights.⁶⁰ Nothing bars after-acquiring stockholders from seeking appraisal and thereby benefiting from the value afforded by these claims. Indeed, stockholders can acquire shares and seek appraisal even after the announcement of the transaction giving rise to appraisal rights, so long as they

⁵⁶Yates, *supra* note 54, at 200.

⁵⁷This is a straight-forward result of the semi-strong theory of market efficiency. The same will be true for a private corporation or any private transaction in which the facts giving rise to the injury are known to both the buyer and seller and the transaction is negotiated at arms' length without any undue compulsion on either party.

⁵⁸*See, e.g.,* *Onti, Inc. v. Integra Bank*, 751 A.2d 904, 932 (Del. Ch. 1999) (valuing derivative claims as an asset in an appraisal and holding that "all litigation must be factored in, and all defenses against it must be considered, in determining the value of contingent claims"); *Gonsalves v. Straight Arrow Publishers, Inc.*, No. 8474, 1996 Del. Ch. LEXIS 106, at *3-4 & n.1 (Del. Ch. Aug. 22, 1996) (finding "strong logic in including the net settlement value of such [derivative] claim[s] as an asset of the corporation for appraisal purposes" and subtracting "attorney's fees . . . from any estimated value").

⁵⁹DEL. CODE ANN. tit. 8, § 262 (2001).

⁶⁰*See Onti*, 751 A.2d at 931-32; *Gonsalves*, 1996 Del. Ch. LEXIS 106, at *3.

hold their shares at the time of the merger.⁶¹ The derivative claim is simply an asset of the corporation, to be valued like any other asset.⁶² The same principles have been applied when determining the value of a corporation in breach of fiduciary duty cases.⁶³

Moreover, albeit in a different context, the Delaware Supreme Court has rejected the "windfall" theory. In *Lewis v. Anderson*,⁶⁴ the Delaware Supreme Court interpreted a different but similar-sounding aspect of section 327, the continuous ownership requirement.⁶⁵ Under this rule, a stockholder pursuing a derivative action must "maintain shareholder status throughout the litigation."⁶⁶ The derivative plaintiffs in *Lewis* owned stock in Conoco.⁶⁷ That entity merged with and into a wholly owned subsidiary of Du Pont in a stock-for-stock merger, with the plaintiffs receiving shares of Du Pont in return for their Conoco shares.⁶⁸ The defendants successfully argued that the plaintiffs lost standing to maintain their derivative action under the continuous ownership rule because they no longer held Conoco stock.⁶⁹ After the merger, Du Pont was the sole stockholder of Conoco, and the plaintiffs held Du Pont stock.⁷⁰

In an effort to avoid dismissal, the plaintiffs responded that application of the continuous ownership rule would "leave a 'wrong' unremedied."⁷¹ They argued that Du Pont and its "New Conoco" subsidiary would not be able to sue

⁶¹*In re* Transkaryotic Therapies Inc., No. 1554-CC, 2007 Del. Ch. LEXIS 57, at *2-3, *10-11 (Del. Ch. May 2, 2007).

⁶²*Nagy v. Bistricher*, 770 A.2d 43, 55-56 (Del. Ch. 2000). The court stated:

[I]n certain circumstances an appraisal proceeding will require the court to value breach of fiduciary duty claims, . . . because those claims are part of the going concern value of the corporation whose entity value is being determined. Put a bit differently, because those claims are assets of the corporation being valued, the court must place a value on those assets in coming to a fair value determination.

Id.

⁶³*See* *Oliver v. Boston Univ.*, No. 16,570-NC, 2006 Del. Ch. LEXIS 75, at *83 (Del. Ch. Apr. 14, 2006), *reprinted in* 32 DEL. J. CORP. L. 242, 277 (2007) ("[I]n determining how the merger proceeds could fairly be allocated, the directors should have evaluated the derivative claims of which they had knowledge during the negotiation and merger processes."); *Bomarko, Inc. v. Int'l Telecharge, Inc.*, No. 13,052, 1994 Del. Ch. LEXIS 51, at *7 (Del. Ch. May 16, 1994) ("[B]reach of fiduciary duty claims that do not arise from the merger are corporate assets that may be included in the determination of fair value."), *aff'd*, 766 A.2d 437 (Del. 2000).

⁶⁴477 A.2d 1040 (Del. 1984).

⁶⁵*Id.* at 1046.

⁶⁶*Id.*

⁶⁷*Id.* at 1042.

⁶⁸*Lewis*, 477 A.2d at 1042.

⁶⁹*Id.*

⁷⁰*Id.*

⁷¹*Id.* at 1050.

"because any recovery would constitute an inequitable windfall" to Du Pont.⁷² The windfall existed, plaintiffs argued, because Du Pont had received full value for its purchase price (in the form of Conoco) and yet would be recovering a portion of the purchase price through the suit.⁷³ The Delaware Supreme Court squarely rejected this argument:

If New Conoco were to proceed against Old Conoco's former management and obtain a recovery, it would not constitute a windfall New Conoco would be simply pursuing Old Conoco's assets [i.e., its derivative claims] and minimizing its liabilities. All such assets and liabilities clearly passed . . . to New Conoco. Such choses in action necessarily included the claim asserted by plaintiff in this action.⁷⁴

The Delaware Supreme Court thus had no difficulty with Du Pont, the new corporate owner of all of the shares of Conoco, causing Conoco to pursue a derivative claim that existed prior to the time when Du Pont acquired the shares and receiving indirectly the benefit from any increase in Conoco's value. The Delaware Supreme Court correctly realized that neither "New Conoco" nor Du Pont received any "windfall" in this circumstance.

The Delaware Supreme Court's recognition that Conoco could bring "derivative" claims for the benefit of its after-acquiring stockholders highlights another oddity of the contemporaneous ownership requirement—it necessarily cannot apply to the corporation asserting a claim directly on its own behalf.⁷⁵ Yet a direct corporate action allows stockholders who bought their shares after the wrong to benefit from the corporation's success, which is precisely the "evil" that the contemporaneous ownership rule seeks to avoid. An after-acquiring stockholder is permitted to lobby the board, use moral persuasion, or even conduct a proxy contest to achieve this result. The only action the after-acquiring stockholder cannot take is to assert the derivative claim itself.

The lone difference between *Lewis* and the typical section 327 situation is that Du Pont, by virtue of its 100% ownership of "New Conoco," could cause Conoco to assert the claims. The same should be true for any after-acquiring stockholder. Subject to the myriad of other limitations that apply to

⁷²*Lewis*, 477 A.2d at 1050.

⁷³*Id.*

⁷⁴*Id.* at 1050-51.

⁷⁵*See, e.g.,* *Shaev v. Whyly*, No. 15,559-NC, 1998 Del. Ch. LEXIS 2, at *14 (Del. Ch. Jan. 6, 1998) ("The contemporaneous ownership requirement . . . was not implicated . . . because the former subsidiary corporation brought suit on its own behalf; no shareholder sued derivatively.").

derivative actions, an after-acquiring stockholder should be able to file suit to compel the corporation to assert a claim. The "windfall" theory for the "evil" of an after-acquiring stockholder bringing a derivative action does not hold together.

E. Preventing Strike Suits

The justification offered most recently by the Delaware courts for the continuous ownership rule is the goal of preventing "strike suits." While the Delaware cases that first mentioned the "strike suit" concept treated it as synonymous with the tactic of buying shares to assert a claim,⁷⁶ more recent cases have presented it as a separate concept in the modern sense of bringing meritless claims for their settlement value.⁷⁷ In a February 2008 opinion, for example, the Delaware Supreme Court commented that "[o]ver time, the stockholder derivative action became stigmatized as a 'refuge of strike suit artists specializing in corporate extortion.'"⁷⁸ The court then stated that section 327 was passed "[i]n response" to this development.⁷⁹

In the same way that section 327 cannot logically address "litigious motives," section 327 likewise cannot logically prevent "strike suits." Section 327 does not distinguish in any way, shape or form between meritless or meritorious claims. It bars any suit by an after-acquiring stockholder,

⁷⁶See *Ala. By-Prod. Corp. v. Cede & Co.*, 657 A.2d 254, 264 n.12 (Del. 1995) ("The long-recognized policy behind Section 327 is to prevent strike suits whereby an individual purchases stock in a corporation with purely litigious motives, i.e., for the sole purpose of prosecuting a derivative action to attack transactions which occurred prior to the purchase of stock."); *Schreiber v. Bryan*, 396 A.2d 512, 516 (Del. Ch. 1978) ("The policy behind the Statute and the Rule is to prevent so-called 'strike suits' whereby individuals purchase shares in a corporation with litigious motives."); *Jones v. Taylor*, 348 A.2d 188, 191 (Del. Ch. 1975).

Turning to the policy behind § 327, it is well recognized that the section was enacted to eliminate strike suits and other abuses which developed along with the derivative suit. The purpose of the rule requiring the plaintiff to be a shareholder at the time of the transaction of which he complains is to prevent what is considered to be a wrong, namely, the purchasing of shares in order to maintain a derivative action so as to attack a transaction which occurred prior to the purchase of stock.

Id. (citations omitted).

⁷⁷See *Conrad v. Blank*, 940 A.2d 28, 41 (Del. Ch. 2007); *Feldman v. Cutaia*, No. 1656-VCL, 2007 Del. Ch. LEXIS 111, at *43 n.64 (Del. Ch. Aug. 1, 2007), *aff'd*, 951 A.2d 727 (Del. 2008).

⁷⁸*Schoon v. Smith*, 953 A.2d 196, 203 (Del. 2008) (quoting Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1348 (1993)).

⁷⁹*Id.*

regardless of merit. There is thus no direct connection between section 327 and an anti-strike suit purpose.

It is possible that section 327 implies a legislative determination that derivative actions by after-acquiring stockholders lack merit and impose a net cost on corporations, the courts, and society such that they, but not other derivative actions, should be eliminated. In other words, the existence of section 327 implies that derivative actions by after-acquiring stockholders have less merit than other derivative claims and, unlike other derivative actions, are harmful.

It is unclear what empirical basis the General Assembly had in 1945 for such a conclusion. None appears in Professor Folk's 1967 report. There also does not appear to be any empirical basis for such a conclusion today. Absent contrary evidence, the logical expectation would be that claims brought by after-acquiring stockholders, on the whole, should not be significantly different than claims brought by existing stockholders. Some would have merit; others would not. If anything, a stockholder purchasing shares with "litigious motives" might be expected to have identified a relatively strong claim so as to make it worthwhile to expend funds both to purchase the shares and to bring the case.

Generally speaking, the types of claims asserted in cases in which the Delaware courts have entered dismissals based on section 327 do not appear facially different, substantially weaker, or otherwise less meritorious than other derivative claims. To the contrary, on several occasions the Delaware Court of Chancery has applied section 327 to bar certain claims, while permitting parallel or similar claims based on later conduct to proceed.⁸⁰

The Delaware practice of permitting a new derivative plaintiff to be substituted into the case when a contemporaneous ownership issue arises further indicates that after-acquiring stockholders are not bringing inherently weaker or harmful claims.⁸¹ If the claims brought by after-acquiring stockholders were inherently different and harmful, then the courts would not permit another plaintiff to pick up and carry forward with the litigation.

⁸⁰*See, e.g., Conrad*, 940 A.2d at 42-43 (finding plaintiff had stated viable claims except where barred by section 327); *Saito v. McCall*, No. 17,132-NC, 2004 Del. Ch. LEXIS 205, at *22-33 (Del. Ch. Dec. 20, 2004), *reprinted in* 30 DEL. J. CORP. L. 650, 659-64 (2005) (finding plaintiff had stated some viable claims but others were barred by section 327).

⁸¹*See, e.g., In re Maxxam, Inc./Federated Dev. S'holders Litig.*, 698 A.2d 949, 951 (Del. Ch. Sept. 10, 1996) (permitting substitution of new derivative plaintiff seven years after the derivative suit originally was filed); *Michelson v. Duncan*, No. 5052, 1980 Del. Ch. LEXIS 511, at *5 (Del. Ch. Apr. 1, 1980) (allowing new derivative plaintiff to intervene after original plaintiff was disqualified).

Conversely, experience has shown that enterprising plaintiffs' counsel can circumvent the contemporaneous ownership requirement through the expedient of having a stable of potential plaintiffs, each of whom holds a small number of shares in a large number of issuers and who can be counted on to lend their name to a lawsuit when the attorney calls.⁸² It is not clear why the DGCL should accept these stockholders as statutorily acceptable plaintiffs but reject after-acquiring stockholders.

There is thus considerable reason to question the implicit premise of section 327 that derivative actions by after-acquiring stockholders are worse than other derivative actions and should be eliminated. Rather, section 327 functions simply to reduce the overall amount of derivative litigation.

Section 327 reduces derivative litigation across the board by rendering finite the universe of stockholders who potentially can bring a derivative claim at the time the wrong occurs. Over time, through purchases and sales of shares, including the ordinary trading of a public float, the universe of stockholders with standing to sue shrinks. This, in turn, results in fewer derivative suits, regardless of their potential merit.

This approach has real costs for the monitoring of fiduciary behavior and enforcing of fiduciary standards. As then-Chancellor William T. Allen observed in 1996, "[I]t is likely that in a public corporation there will be less shareholder monitoring expenditures than would be optimum from the point of view of the shareholders as a collectivity."⁸³ Because all stockholders do not engage in monitoring, the vigorous efforts of some stockholders are essential to the health of the corporate system.

Derivative actions play a significant role in the monitoring of corporate actors.⁸⁴ As Professor Folk explained in his 1967 report, "The ultimate justification for derivative actions both actual and threatened, is their deterrent effect upon insiders tempted to misuse their positions of trust. Severe restrictions upon effective suits cut down the incentive they afford."⁸⁵ Delaware courts regularly praise derivative lawsuits, for example, as "potent tools to redress the conduct of a torpid or unfaithful management."⁸⁶ They

⁸²See, e.g., *In re SS & C Techs., Inc. S'holders Litig.*, 948 A.2d 1140, 1145 (Del. Ch. 2008) (considering motion for sanctions against one of a "web of small investment partnerships" that "filed an unusually large number of stockholder lawsuits [and] . . . are also consistently represented by [plaintiffs' counsel]").

⁸³*Bird v. Lida, Inc.*, 681 A.2d 399, 403 (Del. Ch. 1996).

⁸⁴See *Agostino v. Hicks*, 845 A.2d 1110, 1117 (Del. Ch. 2004) (explaining the need to balance limitations on the derivative action "with the realization that shareholder policing, via derivative actions, is a necessary check on the behavior of directors").

⁸⁵FOLK, *supra* note 5, at 105.

⁸⁶*Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *overruled in part by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

also have been described as "a necessary check on the behavior of directors that serve in a fiduciary capacity."⁸⁷ Professor Folk wrote in his 1967 review that "the premise . . . that all shareholder suits are undesirable and should be discouraged" was explicitly "rejected by this Report."⁸⁸

A rule that denies standing to all after-acquiring stockholder-plaintiffs limits the number of stockholders who can effectively monitor and seek to remedy corporate wrongdoing. The result is less protection against corporate wrongdoing than otherwise would exist, and a greater chance that wrong-doing will go undiscovered and unremedied. By arbitrarily fixing and then shrinking the pool of stockholders who can bring derivative claims, section 327 exacerbates the agency costs inherent in the corporate form.

If derivative actions promote firm value, even marginally, then a rule that forecloses some number of both meritorious and meritless derivative actions will, all things being equal, inherently transfer some degree of wealth from corporations to the individuals who commit corporate wrongs.⁸⁹ This wealth transfer to wrongdoers is the true "windfall" created by section 327.

It is impossible to square the existence of the derivative action and judicial praise of its benefits with a rule that arbitrarily and indiscriminately reduces the overall number of derivative actions without regard to their merit. Section 327 thus cannot be justified as a protection against strike suits. Once again, the rule fails to serve its avowed purpose.

V. THE REALITIES OF MODERN DERIVATIVE LITIGATION

Leaving aside its lack of a coherent purpose, the contemporaneous ownership requirement is unnecessary in the context of modern derivative litigation. From the defendants' standpoint, there are already numerous avenues available to dispose of derivative actions. From the plaintiffs'

⁸⁷ *Agostino*, 845 A.2d at 1117.

⁸⁸ FOLK, *supra* note 5, at 97.

⁸⁹ As a simplistic example, assume a world in which sixty out of one hundred derivative actions have merit and would generate net value for the corporation. These figures are purely hypothetical and are included only to illustrate the concept. I make no claim as to the relative number of derivative actions that have merit. Certainly any study of the subject would need to take into account the typical flurry of derivative actions that are filed in various fora relating to the same alleged wrong, but which typically reduce ultimately to a single consolidated proceeding. Further assume that the contemporaneous ownership rule eliminates five percent of all derivative actions. Given that the rule operates without regard to the merit of the underlying claim, the rule would eliminate three meritorious derivative actions and only two meritless derivative actions. All other things being equal, the rule would produce a net loss of corporate wealth. The situation obviously is reversed if most derivative actions are meritless or otherwise generate a net loss for the corporation.

standpoint, the rule is largely a random inconvenience for lawyer-driven claims.

So significant are the limitations on a stockholder's ability to bring a derivative action that the defendants' success in characterizing an action as derivative (rather than direct) "may be outcome-determinative."⁹⁰ As in any action, defendants can move to dismiss a derivative lawsuit pursuant to Delaware Court of Chancery Rule 12(b)(6) for failure to state a claim upon which relief can be granted. More importantly, defendants can move to dismiss under Delaware Court of Chancery Rule 23.1, thereby invoking the far more powerful requirement that the plaintiff either have made a pre-suit demand on the board of directors to remedy the wrong (thereby conceding the independence of the board to consider the demand) or demonstrate that demand on the board would be futile because at least half of the board is not disinterested or independent.⁹¹ The plaintiff must make this showing with "particularity" and without the benefit of discovery.⁹² It is not an easy motion to survive. Even if the plaintiff runs this gauntlet, the corporation retains the right to form a special litigation committee comprised of independent directors to investigate and decide what to do with the claim, including potentially dismiss it on the merits.⁹³

It is certainly true that "[d]erivative suits may be brought for their nuisance value, the threat of protracted discovery and litigation forcing settlement and payment of fees even where the underlying suit has modest merit."⁹⁴ However, given the existence of powerfully pro-defendant Rule 23.1 jurisprudence, a deep respect for the business judgment rule, and the ultimate fallback of a special litigation committee, defendants in Delaware simply do not need the additional protection of the contemporaneous ownership requirement. If defendants are especially concerned about a particular stockholder having improper motives, they have the power to challenge his suitability to serve as a derivative plaintiff.⁹⁵

From the plaintiffs' side, the contemporaneous ownership requirement ignores the practical reality, readily recognized by Delaware courts, that plaintiffs' counsel and not their nominal stockholder clients are the driving

⁹⁰Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004).

⁹¹See DEL. CT. CH. R. 23.1(a).

⁹²*Id.*

⁹³Agostino v. Hicks, 845 A.2d 1110, 1116 (Del. Ch. 1996).

⁹⁴*Id.* at 1117 n.16 (quoting Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982)).

⁹⁵See, e.g., *In re Dairy Mart Convenience Stores, Inc.*, No. 14,713, 1999 Del. Ch. LEXIS 94, at *31-35 (Del. Ch. May 24, 1999), reprinted in 25 DEL. J. CORP. L. 411, 429-30 (2000) (challenging motivations and suitability of derivative plaintiff that was a competitor of nominal defendant corporation).

force behind derivative litigation.⁹⁶ This is true to the point where a law firm has been permitted to continue in a case without a client.⁹⁷ In the *New Valley* decision,⁹⁸ two derivative complaints were consolidated and the lawyers for the two plaintiffs appointed co-lead counsel.⁹⁹ One of the plaintiffs was dismissed from the lawsuit, leading to a dispute over whether his lawyers could remain in the case.¹⁰⁰ The Delaware Court of Chancery permitted the dismissed plaintiff's counsel to continue without a client based on the unique nature of a derivative action, which it described as "brought on behalf of, and to benefit, not simply the lead plaintiff in the action" but rather "for the benefit of the company and its stockholders."¹⁰¹

In cases falling short of the extreme *New Valley* situation, the contemporaneous ownership requirement is often an inconvenience. As noted, when the issue arises, counsel is usually permitted to substitute a new derivative plaintiff, even years into the case.¹⁰² Thus, the rule only has substantive impact when a replacement plaintiff cannot be found. This, of course, is most likely to happen when a long time has passed since the challenged transaction took place. This is also precisely the situation when defendants already enjoy protection from statutes of limitations¹⁰³ and the doctrine of laches.¹⁰⁴ As a protection against stale claims, the contemporaneous ownership rule is thus redundant.

Given these factors, the substantive impact of the contemporaneous ownership rule is frequently small and largely random. Rather than dismissals

⁹⁶See, e.g., *Cal. Pub. Employees' Ret. Sys. v. Coulter*, No. 19,191-NC, 2004 Del. Ch. LEXIS 64, at *13-15 (Del. Ch. May 26, 2004) (limiting discovery from derivative plaintiff); *In re Fuqua Indus., Inc. S'holder Litig.*, 752 A.2d 126, 133 (Del. Ch. 1999) (declining to disqualify derivative plaintiff who had only a basic understanding of claims). "[T]he mere fact that lawyers pursue their own economic interest in bringing derivative litigation cannot be held as grounds to disqualify a derivative plaintiff." *Id.*

⁹⁷*In re New Valley Corp. Derivative Litig.*, No. 17,649-NC, 2004 Del. Ch. LEXIS 107, at *26 (Del. Ch. June 28, 2004), *reprinted in* 30 DEL. J. CORP. L. 306, 316-17 (2005).

⁹⁸*Id.* at *27, *reprinted in* 30 DEL. J. CORP. L. at 317.

⁹⁹*Id.* at *3-4, *reprinted in* 30 DEL. J. CORP. L. at 307.

¹⁰⁰*Id.* at *25-26, *reprinted in* 30 DEL. J. CORP. L. at 316-17.

¹⁰¹*New Valley*, 2004 Del. Ch. LEXIS 107, at *27, *reprinted in* 30 DEL. J. CORP. L. at 317.

¹⁰²See *supra* note 81 (citing cases where the court permitted a substitute derivative plaintiff to enter the litigation years after its commencement).

¹⁰³See *Halpern v. Barran*, 313 A.2d 139, 141 (Del. Ch. 1973) ("It is by now firmly established that the three-year statute of limitations applies to shareholder derivative actions which seek recovery of damages or other essentially legal relief."); see also DEL. CODE ANN. tit. 10, § 8106 (2008) (setting forth applicable statute of limitations).

¹⁰⁴See *Fed. United Corp. v. Havender*, 11 A.2d 331, 343 (Del. 1940) (noting that the equitable doctrine of laches barred a shareholder from bringing a claim after a delay of only two months).

based on the merits, the rule generates dismissals based on whether a substitute plaintiff can be found.

VI. CONCLUSION

An incoherent rule with rare and largely random effects has no place in the DGCL. Professor Folk's only attempt to justify section 327 was based on the "evil" of the purchased lawsuit. Despite apparent misgivings about the contemporaneous ownership rule, he wrote that "abolishing the Section 327 requirement does not follow, since clearly the policy of eliminating the purchased suit can outweigh the policy of effective private enforcement of fiduciary obligations."¹⁰⁵ As discussed above, the "policy of eliminating the purchased suit" has never been adequately justified and is inconsistent with multiple and equally well-established strains of Delaware law. Without the contemporaneous ownership requirement, it might be that some stockholders would acquire shares with "litigious motives" and bring derivative lawsuits, and it might be that some of those lawsuits would lack merit, but Delaware law in general, and defendants in particular, have effective ways to deal with meritless claims. The more important policy considerations should be to promote the adequate monitoring of fiduciary behavior and ensure that faithless fiduciaries are held accountable. Section 327 should be amended to eliminate the contemporaneous ownership requirement.

¹⁰⁵FOLK, *supra* note 5, at 98.